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The Magnitude of Changes That Would Be Required to Balance the FY2011 Budget

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Summary

A balanced federal budget is a bipartisan goal of many Members of Congress. In addition, moving the budget closer to balance is a long-term necessity because the national debt cannot grow as a percentage of GDP indefinitely, as it would under current policy. The budget deficit in FY2011 is projected to be between $980 billion and $1.27 trillion. Mathematically, the budget could be balanced by reducing total spending by 28%-35%, or mandatory spending by 47%-57%, or discretionary spending by 70%-87%, or by raising income tax rates by 76%-110%. Since non-military discretionary spending is projected to be less than the total budget deficit in FY2011, the budget could not be balanced solely through reductions in this category of spending. The budget is unlikely to return to balance "on its own," as some have suggested, because higher growth rates should be incorporated in the projections; research suggests that the revenue estimates of tax cuts are unlikely to be significantly overstated; and the decline in the deficit found in the CBO baseline for FY2010 to FY2014, or in the President's budget for FY2011 to FY2014, rests on assumptions that differ substantially from what is typically thought of as current policy. This report assumes a familiarity with basic budgetary terms and concepts and will be updated as events warrant.

Many Members of Congress of both parties support the goal of a balanced budget. In addition, moving the budget closer to balance is a long-term necessity because the projected deficits would cause the national debt to grow indefinitely as a percentage of GDP.[1] If this occurred, it would eventually result in financial insolvency. This report lays out generic scenarios for balancing the budget in the next fiscal year. Although these are not policy options that are likely to be enacted, they are meant to offer simple examples to gauge the scope of tradeoffs that would be required if policymakers eventually decide to bring the budget back to balance. If changes are postponed or stretched over a longer time period, they would need to be larger because of higher debt service. (CRS does not take policy positions on the appropriate time frame for balancing the budget.)

Under the Congressional Budget Office (CBO) baseline of current policy, the FY2011 budget deficit is projected to be $980 billion. In the Administration's budget proposal, the deficit would be $1.27 trillion. However, these estimates are unlikely to match actual outcomes for a number of reasons. CBO is required to assume that discretionary spending would grow at the rate of inflation and all expiring tax provisions (including the 2001 and 2003 tax cuts and the alternative minimum tax) would not be renewed, and to project future spending on military operations in Iraq and Afghanistan at the inflation-adjusted level of budget authority provided for the current fiscal year at the time of the projection. The baseline is not meant to offer a "best guess" of future policy.

The Administration's budget proposal depends on congressional enactment and Congress may have other priorities. Even congressional resolutions often turn out to be different from actual results. For example, the actual budget deficit in FY2008 was about $52 billion higher than called for in the conference budget resolution. Keeping these qualifications in mind, the actual deficit, absent policy changes and projection errors, is likely to be closer to the Administration's budget than CBO's baseline because the Administration's FY2011 budget includes supplemental funding required to sustain military and intelligence operations in Afghanistan and Pakistan, and it extends some tax provisions that expire in 2010, including the alternative minimum tax.

The deficit can be eliminated through higher tax revenue, lower spending, or some combination of the two. Using the CBO baseline and the Administration's budget, this report quantifies the scope of changes required to balance the budget through the following options:

- reduce total spending
- reduce mandatory spending
- reduce discretionary spending
- reduce non-military discretionary spending
- raise individual income tax rates
- reduce tax expenditures
- raise individual income tax rates and reduce spending equally

[1] See Congressional Budget Office, *Long-Term Budget Outlook*, June 2009.

Spending Reductions

Rather than single out any specific spending area to bear a disproportionate burden of the reductions, one option would be to spread deficit reduction evenly across all policy areas by $957 billion under the CBO baseline or by $1.24 billion under the Administration's budget.[2] (All policy options are smaller than the deficit because of the resulting reduction in debt service caused by the balanced budget.) Under this option, total non-interest spending would decrease by 28% from the CBO baseline and 35% from the Administration's budget.

About two-fifths of total spending (excluding net interest) is discretionary spending (i.e., spending specifically appropriated by Congress) and three-fifths is mandatory spending. Medicare, Social Security, and other retirement programs account for about two-thirds of mandatory spending, and income support programs account for another one-sixth. To balance the budget solely through decreases in mandatory spending would require reductions of 47% from the CBO baseline and 57% from the Administration's budget. If the deficit were eliminated solely through reductions in discretionary spending, it would need to be reduced by 70% from the CBO baseline and 87% from the Administration's budget.

Discretionary spending is split about evenly between military and non-military spending. Given current military operations abroad and political support for military spending, some policymakers would prefer to limit spending reductions to non-military discretionary spending. Non-military discretionary spending is spread across many policy areas; education and transportation are the largest. Because total non-military discretionary spending is projected to be less than the total budget deficit in FY2011 under both the CBO baseline and the President's budget proposal, the deficit could not be balanced solely through reductions in this category of spending.

Tax Increases

Tax increases could take many different forms and be pursued through many different parts of the tax system. One approach might be an across-the-board increase in marginal individual income tax rates. To balance the budget, average effective individual income tax rates would need to be increased by 76% under the CBO baseline or 110% under the Administration's budget. An approximately equivalent increase in all marginal income tax rates would be needed to raise average tax rates to that extent, assuming no behavioral responses. Because of interactions with the alternative minimum tax, non-refundable tax credits, and so on, marginal tax rates would probably need to be raised by a greater extent to actually achieve a 76%-110% increase in average effective tax rates.[3]

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[2] Researchers have singled out specific policy options for reducing the deficit that they think would be desirable. See, for example, Chris Edwards, "Downsizing the Federal Government," Cato Institute Policy Analysis No. 515, June 2004 and Alice Rivlin and Isabel Sawhill, eds., *Restoring Fiscal Sanity: How to Balance the Budget* (Washington, DC: Brookings Institution Press, 2004); Congressional Budget Office, *Budget Options*, February 2007.

[3] Some policymakers have argued that the fiscal position should be improved by repealing the tax cuts of 2001, 2003, and 2004. According to revenue estimates by the Joint Tax Committee, this policy would reduce the Administration's budget deficit by less than 10% in 2011.

To raise revenue, economists often favor reforms that broaden the tax base rather than raise marginal tax rates.[4] Under a theoretically "ideal" income tax system, the tax treatment of all net income would be the same, regardless of how it is earned or spent. In our current tax structure, tax expenditures (deductions, exemptions, and credits) give special preferences to certain types of economic behavior. While it is beyond the scope of this report to evaluate the effect on efficiency of any particular tax expenditure, it is useful to consider how much revenue could be generated by broadening the base as an alternative to raising marginal tax rates. For example, eliminating only the 10 largest tax expenditures, which include the exclusion for health insurance premiums and deduction for home mortgage interest, would raise approximately $642.7 billion in FY2011, which is more than half of the deficit projected under the Administration's budget proposal.[5]

The large sums involved in the previous examples suggest that some might find it desirable to balance the budget through a combination of tax increases and spending cuts. One option would be to split the revenue difference evenly between overall spending cuts and individual income tax increases. This solution would require a 14% decrease in total spending and a 38% increase in average effective tax rates under the CBO baseline, and a 17% decrease in total spending and a 55% increase in average effective tax rates under the Administration's budget. These options, and those previously discussed, are summarized in **Table 1**.

Table 1. Summary of Selected Policy Options to Balance the Budget in 2011

Policy Option	Percent decrease in spending/increase in taxes from:	
	CBO baseline	**Administration's budget**
Reduce total spending	28%	35%
Reduce mandatory spending	47%	57%
Reduce discretionary spending	70%	87%
Reduce non-military discretionary spending	[a]	[a]
Raise individual income taxes	76%	110%
Raise individual income taxes and reduce spending equally	spending: 14% taxes: 38%	spending: 17% taxes: 55%

Source: CRS calculations based on CBO and OMB projections.

a. For the policy option of reducing non-military discretionary spending, the projected FY2011 deficit amount is greater than the total level of estimated non-military discretionary outlays, and consequently the deficit cannot be eliminated exclusively through the implementation of this policy option.

[4] The Tax Reform Act of 1986 (P.L. 99-514) is a prominent example of an act that broadened the tax base and increased tax revenues (at least initially)—despite reducing marginal tax rates.

[5] Based on OMB estimates of the revenue lost to tax expenditures in 2011 relative to an ideal tax system. This can be considered only a rough estimate because if different tax expenditures were simultaneously reduced, there would be interactions between them that could be higher or lower than the cost of reducing them separately. For examples, see Leonard Berman, "Is the Tax Expenditure Concept Still Relevant?" *National Tax Journal*, September 2003, p. 615.

Will the Budget Deficit Go Away on Its Own?

Some commentators have argued that the drastic policy changes illustrated above will not be necessary because the budget deficit will shrink on its own. They make a number of arguments to support this claim.

First, they point to the improvement in the deficit that occurs over time in the CBO baseline and the President's budget proposal. Both the CBO baseline and the Administration's budget project lower budget deficits during FY2011 to FY2014, before again forecasting deficit increases for FY2015 to FY2020. It is accurate to characterize these projections as requiring significant changes from what is typically considered current policy, however. The CBO baseline assumes discretionary spending will decline 2.7 percentage points from 9.4% of GDP in 2010 to 6.7% of GDP in 2020; discretionary spending has not been this low since 2001. The President's budget proposes an even deeper decline in discretionary spending relative to GDP, to 6.2% of GDP in 2020. The CBO baseline also assumes that many taxpayers will fall under the AMT and all expiring tax provisions will not be renewed, including the 2001 and 2003 tax cuts. The President's FY2011 budget assumes the continuation of some expiring tax provisions and includes an annual $50 billion placeholder for overseas contingency operations in FY2011 and beyond, which would be a dramatic reduction from current overseas military spending levels. If CBO's or the Administration's assumptions are altered to more closely match current policy, the deficit would increase over the next 10 years.[6]

Second, it is argued that faster economic growth will lead to higher revenues than predicted, similar to the experience of the late 1990s. It is true that actual growth was higher than projected in the late 1990s, and this, in turn, caused revenues to be higher than projected. But economic growth in this decade has not matched the higher growth of the 1990s. For example, growth exceeded 3% in seven years from 1992 to 2000. Since 2001, economic growth has exceeded 3% only twice.

The unexpectedly rapid increase in revenue from capital gains realizations was another important element of the "revenue surprise" of the late 1990s. Capital gains revenues rose from $54 billion in 1996 to $119 billion in 2000, but then fell, following the stock market crash, to a estimated $50 billion in 2003. Although capital gains revenues made a strong recovery to $126 billion in 2007, following the 2008 financial crisis, capital gains tax receipts again declined, to an estimated $105 billion for 2008, and $60 billion for 2009.[7] Capital gains receipts would be expected to improve if stock prices continue to rise, but this assumption is already built into CBO's projections.

It should also be noted that the improvement in the budget balance in the 1990s was not just good fortune, but also the result of underlying budgetary decisions. To achieve budget balance, taxes were raised in 1990 (P.L. 101-508) and 1993 (P.L. 103-66) and spending was reduced from 22.3% of GDP in 1991 to 18.2% of GDP in 2000. The largest reduction in spending was defense spending in response to the end of the Cold War. Defense spending fell from 6.2% of GDP in 1986 to 5.4% of GDP in 1991 to 3.0% of GDP in 2000. Spending on non-defense discretionary, Social Security, and interest payments on the debt (because the debt was declining) also fell as a

[6] See CRS Report RL31414, *Baseline Budget Projections: A Discussion of Issues*, by Marc Labonte.

[7] See CBO, *The Budget and Economic Outlook*, January 2010, Table 4-3.

percentage of GDP between 1991 and 2000. Since 2000, spending has risen as a percentage of GDP to 24.7% of GDP in 2009, the highest level as a share of the economy since 1946.

Third, it is argued that the deficit projections are based on faulty assumptions that overestimate the cost of tax cuts because they do not include "feedback effects." It is claimed that, in reality, the tax cuts will cost much less than originally projected because tax cuts spur higher growth, thereby "paying for themselves," at least in part. (The revenue-raising options laid out in this report also assume there will be no feedback effects.) Based on existing theory and empirical evidence, CBO and the Joint Committee on Taxation (JCT) have provided alternative estimates of how much the 2003 tax cuts will cost after allowing for feedback effects on GDP. Assuming that the Federal Reserve does not let inflation rise, JCT found that the tax cuts could cost 5.8%-16.1% less in the first five years, and 2.6%-11.8% less in the next five years. CBO found that the cost of the President's 2004 budget proposals could be between 29% lower and 10% *higher* over the first five years, and between 17% lower and 15% higher over the next five years.[8] This indicates that, under the best case scenario, the feedback effects of the tax cuts would not generate enough revenues to move the budget significantly closer to balance and, under the worst case scenario, could increase the budget deficit more than under "static" revenue estimates. It should also be noted that, to date, there is no evidence that the tax cuts have resulted in less revenue loss than originally projected. After adjusting for economic conditions and temporary factors, revenues have fallen by more than the original "budget scores" for the tax cuts had indicated.[9]

Fourth, it is argued that budget projections are highly uncertain, and may prove to be too pessimistic. This is true: the degree of uncertainty surrounding budget projections dwarfs the projected deficits in the out years of the projections. This means that the permanency of the deficits now projected is far from being a "sure thing." But while the projections may prove to be too pessimistic, it is equally likely that the projections are too optimistic. Although projections made today will certainly prove to be incorrect, the probability that the budget deficit will turn out to be higher than predicted is equal to the probability that it will turn out to be lower than predicted.

The Burden of the Status Quo

Many would consider the policy options laid out in this report to be too burdensome to be feasible. But in mainstream economics, a budget deficit imposes a burden that is just as real as higher taxes or spending cuts. Deficits can be financed only by borrowing real resources. When these resources are borrowed out of American saving, the budget deficit pushes up interest rates and "crowds out" private investment spending that is necessary to increase future standards of living. In effect, this outcome shifts the burden of the deficit to future generations by causing future living standards to be lower than they otherwise would be. When the resources are borrowed from foreigners, the trade deficit widens and foreigners, rather than Americans, enjoy the returns from that borrowing. Balancing the budget shifts a burden, but it does not create one.[10]

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[8] Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for FY2004*, March 2004; Congressional Budget Office, *How CBO Analyzed the Macroeconomic Effects of the President's Budget*, July 2003; Joint Committee on Taxation, "Macroeconomic Analysis of H.R. 2," *Congressional Record*, Doc 2003-11771, May 8, 2003. For a discussion, see CRS Report RL31949, *Issues in Dynamic Revenue Estimating*, by Jane G. Gravelle.

[9] See CRS Report RS22550, *The Federal Budget: Sources of the Movement from Surplus to Deficit*, by Marc Labonte.

[10] See CRS Report RL30520, *The National Debt: Who Bears Its Burden?*, by Marc Labonte. A trade deficit is the (continued...)

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necessary result of borrowing abroad because borrowing can only occur if Americans spend more abroad than foreigners spend on American goods.